



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-124627-11]

RIN 1545-BK43

Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Notice of proposed rulemaking

SUMMARY: This document contains proposed regulations concerning the continuity of interest requirement for corporate reorganizations. The guidance is necessary to clarify the manner in which the continuity of interest requirement is measured in particular circumstances. The proposed regulations affect corporations and their shareholders.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-124627-11), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8:00 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-124627-11), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or electronically, via the Federal e-Rulemaking Portal at <http://www.regulations.gov/> (IRS REG-124627-11).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations,

Richard Starke (202) 622-3497, and concerning submission of comments, Oluwafunmilayo Taylor (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This notice of proposed rulemaking accompanies publication of final regulations regarding the continuity of interest requirement (COI) for corporate reorganizations that are published in this issue of the **Federal Register** (the 2011 regulations). In general, the 2011 regulations provide the circumstances under which the consideration to be exchanged for the proprietary interests in the target corporation is valued on the last business day before the first date there is a binding contract (the signing date rule). The preamble explains that the signing date rule is based on the principle that where a binding contract provides for fixed consideration, the target corporation shareholders can generally be viewed as being subject to the economic fortunes of the issuing corporation as of the last business day before the signing date (the Pre-Signing Date). However, if the contract does not provide for fixed consideration, the signing date value of the issuing corporation stock is not relevant for purposes of determining the extent to which a proprietary interest in the target corporation is preserved. For additional background regarding the signing date rule, see the preamble to the 2011 regulations published elsewhere in this issue of the **Federal Register**.

Explanation of Provisions

In response to comments, the IRS and the Treasury Department have reconsidered the scope of the signing date rule, and agree that its underlying principles support additional methods for determining whether COI is satisfied. For example, a

contract to effect a potential reorganization may provide that the amount of an item of consideration will vary as the value of issuing corporation stock declines between the stock's Pre-Signing Date value and some lower value provided for in the contract (Floor Price), but will not vary below the Floor Price. If the closing date value is less than the Floor Price in such a case, the target shareholders have been subjected to the economic fortunes of owning the consideration received in the exchange in the same manner as if the contract had fixed the consideration based upon the contract's stated Floor Price. Accordingly, these proposed regulations generally provide that if, pursuant to a binding contract, an item of consideration varies as the value of issuing corporation stock declines between the stock's Pre-Signing Date value and a Floor Price, and the closing date value is less than the Floor Price, COI is determined as if the consideration that would have been delivered at the Floor Price were issued and valued based upon the Floor Price. Applying the same principle, these proposed regulations provide that if, pursuant to a binding contract, an item of consideration varies as the value of issuing corporation stock increases between the stock's signing date value and some higher value provided for in the contract (Ceiling Price), and the closing date value is greater than the Ceiling Price, COI is determined as if the consideration that would have been delivered at the Ceiling Price were issued and valued based upon the Ceiling Price. For purposes of this rule, the Closing Date means the date upon which the exchange of consideration in the potential reorganization occurs.

In response to comments, these proposed regulations also permit, in lieu of the value of issuing corporation stock on the Closing Date, the use of an average value for issuing corporation stock in certain circumstances. The proposed regulations provide

that an average value may be used if it is based upon issuing corporation stock values occurring after the signing date and before the Closing Date, and the binding contract utilizes the average price, so computed, in determining the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation. This rule also applies signing date rule principles because the average value fixes the number of shares and amount of other consideration. Accordingly, the target shareholders become subject to the fortunes of the issuer's stock across the range of dates being averaged.

Request for Comments

As previously stated, the signing date rule and these proposed regulations are based upon the concept that for purposes of measuring COI, in certain circumstances an item of consideration provided by the issuing corporation can generally be valued on the date that the target shareholders become subject to the economic fortunes of owning the item, assuming the exchange ultimately occurs. Depending upon the contract's terms, this may occur on a date between the signing date and the closing date, and may occur for different items of consideration on different dates. Accordingly, for purposes of COI, it may be appropriate to value an item of consideration on a date between the signing date and the closing date, and to value different items on different dates. For example, future guidance could provide that an item of consideration is valued for COI purposes at the earliest date on which the target shareholders (in the aggregate) become fully subject to the appreciation and depreciation in the value of that item pursuant to a binding contract to effect the potential reorganization, but not later

than the date of the reorganization exchange. In determining whether the target shareholders are fully subject to market appreciation and depreciation, certain circumstances, such as the risk of not closing, would be disregarded. The IRS and the Treasury Department request comments on the propriety of such an approach.

Effective Date

These regulations are proposed to apply to transactions occurring on or after the date the regulations are published as final regulations in the **Federal Register**, unless completed pursuant to a binding agreement that was in effect immediately before the date such final regulations are published and all times afterwards.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866 as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that 5 U.S.C. 553(b) does not apply to these regulations and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and

copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Richard Starke of the Office of Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.368-1 is amended by adding new paragraphs (e)(2)(vi), (e)(2)(vii), and revising (e)(9) to read as follows:

§1.368-1 Purpose and scope of exception of reorganization exchanges.

* * * * *

(e) * * *

(2) * * *

(vi) Special Rules--(A) Floors. This paragraph (e)(2)(vi)(A) applies if, pursuant to a binding contract, the amount of an item of consideration to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary

interest in the target corporation, changes as the value of a share of the issuing corporation varies above a specified price (Floor Price), but does not vary below the Floor Price. If the value of the share is greater than or equal to the Floor Price on the Pre-Signing Date (as defined in paragraph (e)(2)(i) of this section) but below the Floor Price on the Closing Date (as defined in paragraph (e)(2)(vi)(D) of this section), whether a proprietary interest is preserved is determined as if the consideration was issued and valued based upon the Floor Price.

(B) Ceilings. This paragraph (e)(2)(vi)(B) applies if, pursuant to a binding contract, the amount of an item of consideration to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation, changes as the value of a share of the issuing corporation varies below a specified price (Ceiling Price), but does not vary above the Ceiling Price. If the value of the share is less than or equal to the Ceiling Price on the Pre-Signing Date (as defined in paragraph (e)(2)(i) of this section) but above the Ceiling Price on the Closing Date (as defined in paragraph (e)(2)(vi)(D) of this section), whether a proprietary interest is preserved is determined as if the consideration was issued and valued based upon the Ceiling Price.

(C) Closing Date value--average values between signing date and Closing Date. In determining the Closing Date value of issuing corporation stock for purposes of determining whether a proprietary interest in the target corporation is preserved, an average of prices may be used in lieu of the Closing Date price if –

(1) The average price is based upon prices of issuing corporation stock occurring after the signing date and before the Closing Date, and

(2) The binding contract utilizes the average price, so computed, in determining the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation.

(D) Closing Date. For purposes of paragraphs (e)(2)(vi) and (e)(2)(vii) of this section, the Closing Date means the date upon which the exchange of consideration in the potential reorganization occurs.

(vii) Examples. For purposes of the examples in this paragraph (e)(2)(vii), P is the issuing corporation, T is the target corporation, each corporation has only one class of stock outstanding, no transactions other than those described occur, and the transactions are not otherwise subject to recharacterization. The following examples illustrate the application of paragraph (e)(2)(vi) of this section:

Example 1. Price adjustment to provide more or less cash. (i) Facts. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged into P. Pursuant to the contract, the T shareholders will receive 50 shares of P stock and \$50 cash in exchange for all of the outstanding shares of T stock, subject to the following price adjustment:

(A) If the average price of P stock over the five-day period prior to the Closing Date exceeds \$1, the amount of cash will be reduced by 50 times the excess of that price over \$1, and

(B) If the average price of P stock during the specified period is less than \$1, the amount of cash will be increased by 50 times the excess of \$1 over that price, provided that in no event will P deliver cash of less than \$40 or more than \$60 to the T shareholders. This adjustment ensures that the T shareholders will be entitled to receive aggregate consideration with a value of \$100 on the closing date if the average price of P stock during the specified period is between \$.80, at which point the T shareholders would receive \$60 of cash ($\$50 + ((\$1 - \$.80) \times 50)$), and \$1.20, at which point the T shareholders would receive \$40 of cash ($\$50 - ((\$1.20 - \$1) \times 50)$).

(C) On January 2 of year 1, the value of the P stock is \$1 per share. On June 1 of year 1, T merges into P, when the value of P stock is \$.25 per share. The average price of P stock during the specified period is also \$.25 per share. In the merger, the T shareholders receive \$60 cash and 50 shares of P stock with a value (determined as of the Closing Date) of \$12.50.

(ii) COI determined at the Floor Price. For purposes of determining whether a proprietary interest in the target corporation is preserved, the rules of paragraph (e)(2)(vi)(A) of this section apply because, pursuant to a binding contract, the amount of cash to be exchanged for all the proprietary interests in the target corporation varies above a Floor Price of \$.80 but does not vary below the Floor Price, the Pre-Signing Date value exceeds the Floor Price, and the value on the Closing Date is less than the Floor Price. Accordingly, whether a proprietary interest is preserved is determined as if the consideration that would have been delivered at the Floor Price was issued and valued based upon the Floor Price value. At the Floor Price, the T shareholders would have received, in the aggregate, \$60 of cash and \$40 of P stock. Therefore, the transaction satisfies the continuity of interest requirement.

Example 2. No Floor Price. The facts are the same as in Example 1, except that the Pre-Signing Date value is \$.50, the Closing Date value is \$1.50, and there is no limitation on the amount of additional cash that the T shareholders may receive (that is, there is no Floor Price). For purposes of determining whether a proprietary interest in the target corporation is preserved, the rules of paragraph (e)(2)(vi)(B) of this section apply because, pursuant to a binding contract, the amount of cash to be exchanged for all the proprietary interests in the target corporation varies below a Ceiling Price of \$1.20 but does not vary above the Ceiling Price, the Pre-Signing Date value is less than the Ceiling Price, and the value on the Closing Date exceeds the Ceiling Price. Accordingly, whether a proprietary interest is preserved is determined as if the consideration that would have been delivered at the Ceiling Price was issued and valued based upon the Ceiling Price. At the Ceiling Price, the T shareholders would have received, in the aggregate, \$40 of cash and \$60 of P stock. Therefore, the transaction satisfies the continuity of interest requirement.

Example 3. No Floor or Ceiling Price. (i) Facts. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged into P. Pursuant to the contract, the T shareholders will receive \$50 cash and \$50 of P stock based upon the P stock value on the Closing Date. On January 2 of year 1, the Pre-Signing Date, the value of the P stock is \$1 per share. On June 1 of year 1, when the value of P stock is \$5 per share, T merges into P.

(ii) COI determined on the Closing Date. For purposes of determining whether a proprietary interest in the target corporation is preserved, the rules of paragraph (e)(2)(vi) of this section do not apply because the contract does not provide for a either a Floor Price or a Ceiling Price. There is no Floor Price because there is not a value below which the amount of P stock will not vary. There is no Ceiling Price because there is not a value above which the amount of P stock will not vary. Because the transaction does not satisfy the requirements of paragraph (e)(2)(vi) of this section and

does not satisfy the definition of fixed consideration, the consideration will be valued on the Closing Date. The transaction satisfies the continuity of interest requirement because the T shareholders receive, in the aggregate, \$50 cash and \$50 of P stock.

* * * * *

(9) Effective/Applicability date. Paragraphs (e)(2)(vi) and (e)(2)(vii) are proposed to apply to transactions occurring on or after the date the regulations are published as final regulations in the **Federal Register**, unless completed pursuant to a binding agreement that was in effect immediately before the date such final regulations are published and at all times afterwards.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2011-32079 Filed 12/16/2011 at 8:45 am; Publication Date: 12/19/2011]